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In the Supreme Court of the United States

OCTOBER TERM, 1963

No. —

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CLAY B. BROWN AND DOROTHY E. BROWN, DONALD L. BROWN AND INGRID R. BROWN, CHARLES WILLIAM BOOTH AND NANCY H. BOOTH, DONALD LEE BROWN, PHILLIP F. BROWN, MARILYN BROWN

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgments of the United States Court of Appeals for the Ninth Circuit in the above-entitled case.

OPINIONS BELOW

The opinion of the Tax Court (R. 17–81)[1] is reported at 37 T.C. 461. The opinion of the court of appeals (App. 37–43) is reported at 325 F. 2d 313.

[1] "R." refers to the Transcript of Record printed for use in the court of appeals; "App.", to the appendix to this petition.

JURISDICTION

The judgments of the court of appeals were entered on December 10, 1963 (App. 44). By orders dated March 11, 1964, and April 3, 1964, Mr. Justice Douglas extended the time for filing a petition for certiorari to April 24, 1964. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether a purported sale of a business to a charity in which the charity makes no down payment, pledges no assets, assumes no personal liability, and provides no managerial services, with the "purchase price" being payable solely out of the income of the business and with the "seller" having recourse, in the event of default, solely against the assets of the business, constitutes a "sale" of the business within the meaning of § 1222(3) of the Internal Revenue Code of 1954 (and § 117(a)(4) of the 1939 Code), thereby entitling the "seller" to report his subsequent receipts of the earnings of the business as capital gains rather than as ordinary income.

STATUTE INVOLVED

Section 1222(3) of the Internal Revenue Code of 1954 (26 U.S.C., 1958 ed.) [1] provides that:

> The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months * * *.

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[1] § 117(a)(4) of the 1939 Code (26 U.S.C., 1952 ed.) is identical.

STATEMENT

The facts are set forth in detail in the findings of the Tax Court (R. 18–57). For present purposes, an abbreviated statement will suffice.

1. Respondents are the former stockholders of Clay Brown & Company, a corporation engaged in lumber milling. Respondent Clay B. Brown was president of the company and, with his wife and children, owned 94% of the stock. The balance was owned by two other officers of the company[3] (R. 21).

In February 1953, pursuant to a pre-arranged plan, the following occurred: Respondents conveyed their stock[4] to the West Los Angeles Institute for Cancer Research. The Institute liquidated the corporation, paid respondents $5,000 from the proceeds as a down payment, and then "leased" the remaining assets[5] to Fortuna Mills, Inc., a newly-formed corporation owned by respondents' attorneys. Under the terms of the "lease," Fortuna was to operate the mill and pay over to the Institute, as "rent," 80% of the net profits before taxes or depreciation. The lease was for a five-year term and required Fortuna

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[3] One of the officers, C. A. Hill, owning about 1.5% of the stock, is not a party to these proceedings but for convenience we will refer to respondents as including all of the stockholders.

[4] Notes against the corporation in the amount of $125,000, held by Clay Brown and his wife, were also conveyed and cancelled as part of the transaction, but for simplicity we will treat the conveyance as being solely of stock.

[5] Except for the current assets, which were sold to the lessee in exchange for its assumption of the corporate debts and its note for the excess of the current assets over the liabilities assumed (approximately $21,000) (R. 42–43).

to employ Clay Brown as general manager for the period of the lease. In exchange for the stock, the Institute gave respondents a nonnegotiable, noninterest-bearing, note in the amount of $1,300,000, maturing in ten years and secured by a mortgage on the assets of the liquidated corporation.* The Institute was not personally liable on the note. The limit of its obligation was to make payments equal to 90% of whatever "rents" it received from Fortuna. If the payments fell below $250,000 in any two-year period, respondents were entitled to declare the entire balance due and, upon default, to foreclose (R. 37–44). In brief, respondents conveyed their stock to the Institute in exchange for a right to 72% (90% of 80%) of the net profits of the business until they had received $1,300,000.

The negotiations looking to the transaction had been initiated by the Institute, which provided respondents with brochures describing the advantages to the owners of a business of such a "sale," among them being that they could sell the business for more than they could for cash, continue to control the business operations and draw their regular salaries, and yet pay only a capital-gain tax on the proceeds (R. 23–25). The Institute had no prior relationship to respondents; the purchase price was arrived at through arm's-length negotiations; and the Institute's only reason for entering into the transaction was the anticipated financial gain to itself (*i.e.*, the receipt

*The note the Institute received from Fortuna for the current assets (see note 5, *supra*) was also assigned to respondents as security.

of 10% of the "rents" during the period of payment and the prospect of owning the business outright after payment was completed) (R. 36, 57).

2. Simultaneously with the above transactions, Fortuna employed respondent Clay Brown as general manager at his former salary ($25,000), and the business continued in operation, without interruption, on the same premises and with the same personnel (R. 44, 47).[7] During the years 1953–1956, the Institute paid over to respondents a total of $651,094 out of the "rents" it received from Fortuna (R. 56). Beginning in November 1956, the mill suffered heavy losses as a result of a decline in lumber prices, and in June 1957 the mill was shut down (R. 50). Pursuant to a further agreement of the parties (entered into in lieu of foreclosure), the Institute sold the properties to third parties in 1958 for $300,000, retained 10% of the proceeds, and paid the balance ($262,096, after costs of sale) over to respondents in settlement of all obligations (R. 54–55).[8]

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[7] As required by the lease, Clay Brown was originally employed for a five-year term (R. 30). In November 1954, however, Clay Brown's attorney advised him of a recent revenue ruling involving a similar transaction and recommended that, among other things, the requirement of a management contract be eliminated (R. 49). Clay Brown then resigned as general manager, effective October 31, 1954, and waived his rights under the lease to approve his successor. He continued to be retained (at a salary of $12,000) in an advisory capacity with the authority to sign corporate checks, but he was succeeded as general manager by respondent Booth (R. 48, 123, 125–126).

[8] Respondents also received $20,849 from Fortuna in payment of its assigned note for the current assets (see notes 5 and 6, *supra;* R. 51, 56).

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3. Only the taxable years 1953–1956 (*i.e.*, prior to the default) are involved in this case. Using the installment method, each respondent reported his gains for each year as long-term capital gain. The Commissioner of Internal Revenue held that the transaction was not a "sale" within the meaning of § 1222(3) of the Internal Revenue Code of 1954[9] and that the gains were taxable as ordinary income, determining deficiencies accordingly (R. 57).

The full Tax Court (R. 57–72), with six judges dissenting (R. 72–81), held the transaction a "sale" and the gains taxable only as capital gains. The court noted that "It may be * * * that [respondents] would have been unable to sell the stock at as favorable a price to anyone other than a tax-exempt organization," but said that a taxpayer has the right "to increase the amount received from a transaction over what he might have received from a different transaction" and that a sale is not to be ignored "solely because the exempt organization is willing to pay a somewhat higher price than someone else might pay" (R. 62).[10]

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[9] The first year involved is governed by the 1939 Code, § 117 (a)(4) of which is identical, but for convenience all section references in this petition will, unless otherwise indicated, be to the 1954 Code.

[10] The price was, moreover, a "result of real negotiating" and "within a reasonable range in light of the earnings history of the corporation and the adjusted net worth" (R. 64), confirming that the Institute acted at arm's-length with a real expectation that the earnings would be sufficient to permit full payment and that there was no "tacit understanding" that the transaction would collapse, permitting respondents to recover possession (R. 63–64, 36).

The court of appeals affirmed (App. 37–43). Although acknowledging that the transaction took the form it did because the Institute was tax-exempt and that "the price to be paid was probably greater for that reason" (App. 42), it held that the transaction was a "genuine sale" because there was a transfer of title, of permanent ownership, of the benefit of part of the current income, and of the operation of the business (App. 41–42).

REASONS FOR GRANTING THE WRIT

This is a tax case of rare importance. Its importance lies both in the fundamental character of the question of statutory interpretation involved—what constitutes a "sale" for purposes of the capital-gains provisions—and in the social, economic, and revenue implications of the particular transaction in issue—"bootstrap" sales of businesses to charities.

The character of the transaction in this case is obscured by its complexity, which in turn is attributable to the effort to combine the advantages of the "bootstrap" technique with those flowing from the Institute's tax exemption. In order to separate the elements of the transaction, we will consider first a simpler form of "bootstrap" sale to a non-exempt purchaser and show the nature and importance of the questions such as transaction presents. We will then show how that device has been exploited, and its advantages magnified, in sales, as here, to charitable foundations.

I.

A "bootstrap" sale—so called because the business in effect buys itself—is one in which the "buyer"

makes no down payment,[11] pledges no assets, assumes no meaningful personal liability, and provides no managerial services. As a consequence, the "seller" can look only to the income and assets of the very business transferred for payment of the "purchase price." Since an owner is entitled to *all* the income and assets of the business, a transaction in which he limits his claims against it to a stated maximum amount (the "purchase price"), receiving nothing from the "buyer" and continuing to bear all the risks of the business, makes no economic sense. As we will demonstrate, it is but an elaborate device for the attempted conversion of ordinary business earnings into capital gains.

1. Suppose that *A* owns all the stock of a corporation, *X*, currently producing $100,000 a year in after-tax income. The business is relatively speculative, and the most that *A* could receive for his stock in cash (or from a solvent purchaser who would make a substantial down payment) is $500,000. *B*, however, proposes to buy the stock on the following terms: *B* will create corporation *Y* with a paid-in capital of $100; *A* will transfer his *X* stock to *Y*; *Y* will liquidate *X*, take over its assets, and employ *A* to continue to manage the business; and *Y* will give *A* its corporate notes, payable $100,000 a year and secured by a mortgage on the acquired assets, in whatever total face amount the parties agree upon as the "purchase price" for *A*'s stock. In short, *A* is to sell his half-

[11] *I.e.*, other than, as here, out of the very assets transferred.

million-dollar business to *B*'s penniless corporation solely for the notes of that corporation, the purest and simplest form of a bootstrap sale.

Assuming that *A* and *B* are wholly unrelated and that there is no desire to make a gift, the "price" they agree upon will necessarily be greater than $500,000: with no equity or "cushion" to secure their payment, notes from *Y* for $500,000 would be worth considerably less than their face value,[12] and at that price *A* could have gotten cash or adequate security and been relieved of any further risk, whereas in the proposed transaction he is to continue to bear the full risk of loss. On the other hand, neither economics nor fairness imposes an upper limit on the price. *A*, who begins with everything and is to continue even to manage the business, is entitled to the fruits of the business without limit so long as he is to receive nothing else. *B*, who is to put up nothing and to assume no obligations, is entitled to nothing and has no complaint to make to any price. There is nothing

[12] That would be so even if, as is not the case here, the notes bore interest, for the simple truth is that no amount of notes against a corporation, with or without interest, can ever be worth quite so much as full ownership of its assets, which is what *A* is to give up. The absence of stated interest, however, makes even more blatant the attempted conversion of ordinary income into capital gain (see note 14, *infra*). We do not emphasize that aspect of the case here, not because we do not believe it is an important element, but because it is only a part of the story, and the rest of the story is what differentiates bootstrap sales from various other transactions in which interest is also disguised.

to bargain about, and however high the price is set—say, $5 million payable $100,000 a year for 50 years—it will still be less than a "reasonable" one and *A* will still be surrendering the ultimate ownership of the business to *B* for nothing.

There being no economic determinants of the price, the upward limit can be determined only by tax considerations. To make the transaction look like a "sale," there must, of course, be a "price" of some sort, and the tax commentators uniformly advise that it not be set too high lest the device be made transparent.[12] The optimum price will be that at which the tax gains, discounted by the tax risks, will exceed the economic loss by the maximum amount. Thus, while a price 10 or 20 times the value of the business would make as much (indeed, more) economic sense, *A* would presumably seek to lessen the tax risks by settling for a more modest figure—in the range, say, of $1 million to $2 million.

The tax gains from such a transaction, treated as a "sale," are apparent, for the earnings of the business paid over to *A* during the period of the pay-out will be taxed only as capital gains rather than as

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[12] See Moore and Dohan, *Sales, Churches and Monkeyshines*, 11 Tax L. Rev. 87 (1956); MacCracken, *Selling a Business to a Charitable Foundation*, 1954 U. of So. Calif. Tax Inst. 205; Comment, *The Three-Party Sale and Lease-Back*, 61 Mich. L. Rev. 1140 (1963); Alexander, *The Use of Foundations in Business*, 15 N.Y.U. Tax Inst. 591; *New Developments in Tax-Exempt Institutions*, 19 Journal of Taxation 302 (1963). For commentaries critical of the judicial treatment of such transactions, see Lanning, *Tax Erosion and the "Bootstrap Sale" of a Business*, 108 U. of Pa. L. Rev. 623 (1960); Moore and Dohan, *supra*.

ordinary income (as they would have been if received as dividends). The difference in the tax rates will, in turn, more than compensate for the economic loss (*i.e.*, the sacrifice of the residual interest). The net gain can be illustrated by making the neutral assumption that the after-tax earnings ($100,000) and cash value ($500,000) of the business remain constant throughout the period of the pay-out and by comparing the after-tax results with the results had *A* retained his stock, and received the earnings as dividends, for the same period and then sold the business for its cash value. We will assume that *A*'s basis for the stock (often, as here, quite low) is zero and that he is in an 80% tax bracket.

In a bootstrap sale for $2 million, *A* would receive only the annual payments of $100,000 for 20 years and then have no further interest in the business. His $2 million receipts, however, would be taxed only at the maximum capital-gains rate of 25% and he would have $1,500,000 left after taxes. If he retained the business for 20 years and then sold it, he would receive not only its 20-year earnings of $2 million but also an additional $500,000 on its sale at the end of that time. In that event, however, his $2 million in annual receipts would be taxable as dividends at an 80% rate, leaving him with only $400,000, which together with his $375,000 in after-tax receipts from the cash sale of the business ($500,000 taxable as capital gains) would give him a total of only $775,000. The after-tax proceeds of a $2 million bootstrap sale are thus almost double ($1,500,000) those of a reten-

tion and cash sale ($775,000).[14] On the same comparison, a bootstrap sale at the more modest price of $1 million (10-year pay-out) is still highly profitable, yielding $750,000 after taxes as compared with $575,000 for a retention and cash sale.[15]

2. Although such a transaction makes no economic sense and can be explained only by the hoped-for tax benefits, we do not deny that it has "substance", is "real" and not a "sham", and may result ultimately in a transfer of full ownership. Whether the "substance" of the transaction is that of a "sale," however, depends on what the "substance" of a "sale" is—*i.e.*, on the meaning of that word as used in the statute. It is that question of statutory interpreta-

[14] Another revealing comparison is to a bootstrap sale with interest on the deferred payments. A sale at $1,300,000 with 4½% interest would produce the same total payments ($100,000 a year for 20 years), but $700,000 of *A*'s $2 million receipts would then be taxable as interest income at an 80% rate ($140,000 after taxes) and only $1,300,000 would receive capital-gains treatment ($975,000 after taxes), producing total after-tax receipts of only $1,115,000. A sale at $1,147,000 with 6% interest would yield the same payments but only $1,030,850 after taxes. As those examples show, the disguising of the interest element—*i.e.*, stating the price as $2 million without interest rather than as $1.3 million with 4½% interest—accounts for a substantial part (though by no means all) of the tax benefits. In bootstrap sales to exempt purchasers, as we will show (see pp. 24–25, *infra*), a much more rapid pay-out is possible, with the result that the disguising of the interest element accounts for relatively less (and the "bootstrap" element, relatively more) of the overall tax advantage.

[15] In sales to exempt purchasers, the relative advantages are considerably greater, so the price may be set even lower and still yield a profit. See note 8, *infra*.

tion, so fundamental to the application of the capital-gains provisions, that this case presents.

In our view the essential characteristic of a "sale" is a realization upon the present value of an asset by its conversion into other property, with the consequence that the seller abandons his interest in the future income from the asset and, concomitantly, insulates himself from the risk of future losses. Its essence is a present realization upon the values that have accrued in the past and a termination of the seller's interest in the future—a "cashing in" on the present value of the asset and a shifting of the benefits and burdens of future gains and losses to others. A "sale", in short, is a relinquishment of the future for the present, and no transaction which does not possess that characteristic in some substantial degree is, we submit, entitled to capital gains treatment.

An expression in such general terms of the basic "idea" of a sale does not, to be sure, provide a mechanical definition that may be easily applied to all possible cases. Questions of degree calling for an exercise of judgment will always remain,[16] but judgment cannot be exercised in a vacuum, and before a court

[16] Most obvious, of course, is the question of "how much" of a down payment or credit cushion is necessary to cause a sufficient shifting of the risk to justify "sale" treatment, a question requiring an appraisal, for example, of such imprecise factors as the stable or speculative nature of the business. Another important variable is whether the "buyer" is to manage the business, for the provision of management skills is itself an investment put at risk by the "buyer" which gives the "seller" something different than he had before.

can say whether a particular transaction is a "sale" it must first have some notion, however unmathematically expressed, of what a "sale" is. And there are many cases—including, as we will show, this one—in which even so general a formulation will provide a ready answer.

The restriction of "sales" to cashing-in, risk-shifting, interest-terminating transactions is required by the basic purpose of the capital-gains provisions, which, as this Court has repeatedly recognized, was to afford relief from the application of the steeply progressive ordinary rates to the realization in a single year of values that may have accrued over many years in the past. See, *e.g.*, *Commissioner* v. *Gillette Motor Co.*, 364 U.S. 130, 134; *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260, 265; *Burnet* v. *Harmel*, 287 U.S. 103. That purpose obviously does not warrant extending capital-gains treatment to annual receipts derived from a *continuation* of risk-bearing and dependent entirely upon the earnings of the business.

Even more pointed for present purposes are the decisions of this Court in the natural-resources field, establishing that a transaction in which the purported "seller" retains an "economic interest" in the property does not qualify as a "sale." While an outright sale of mineral interests by a landowner qualifies for capital gains treatment, a purported sale of the mineral interests in exchange for a royalty from the minerals produced is treated only as a lease and the royalty payments are fully taxable as ordinary income (*Burnet* v. *Harmel*, 287 U.S. 103) and eligible for the depletion

allowance (*Palmer* v. *Bender*, 287 U.S. 551)." Most closely analogous is a "sale" of the minerals for a nominally fixed price, but with the "price" being payable only out of production (*e.g.*, a "sale" of all the minerals in place for $1 million payable out of ⅝ of the first production). Because such an "oil production payment" is payable only if and when oil is produced, the seller is held to have retained an "economic interest" in the future production and hence not to have made a "sale" of the property, notwithstanding that the transaction is effective to convey title as a matter of state law and that, once the pay-out is completed, full ownership of the minerals will vest in the "purchaser." *Thomas* v. *Perkins*, 301 U.S. 655." What we contend

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[17] While the character of the transferor's receipts and his right to depletion deductions are closely related, the questions are not necessarily coterminous. In two of the earlier depletion cases, the Court seemingly viewed depletion as depending upon having an interest in the minerals in kind and denied depletion to a transferor who received simply a "personal covenant" of the transferee to pay over a share of the "net profits" from the operation of the properties. *Helvering* v. *O'Donnell*, 303 U.S. 370; *Helvering* v. *Elbe Oil Land Co.*, 303 U.S. 372. The continued vitality of those decisions is questionable in view of the later decisions in *Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599, and *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25 (see also *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308), and they were in any event peculiarly concerned with the depletion question.

[18] See also *Palmer* v. *Bender*, 287 U.S. 551. Compare *Anderson* v. *Helvering*, 310 U.S. 404, where there was a down payment of almost one-third of the price and the balance, with 6% interest, was payable either out of production or from a sale of the properties. Because the payment was not dependent solely upon production and the property itself furnished security (en-

for here is neither more nor less than the "economic interest" doctrine which this Court has applied to purported "sales" of minerals but which the lower courts have unaccountably refused to apply to "sales" of businesses."[19]

The characteristics essential to a "sale" are, of course, unmistakably present in a transfer of property in exchange for immediate and full payment in cash or other property. They are also present in—are, indeed, the essence of—a credit sale in which the buyer

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hanced, it should be noted, by the substantial down payment), the Court, distinguishing *Perkins* on that ground, held the transaction to be a sale.

[19] Our brief discussion of the merits, necessary to show the basic nature of the question presented, does not of course begin to exhaust the support that may be marshalled for the concept of a "sale" as a risk-shifting, interest-terminating transaction. The "reorganization" provisions, for example, reflect a Congressional recognition that a transaction in which the transferor's investment remains "at risk" in substantially the same business should not be treated as a "sale or exchange"; and in distinguishing "sales" from "reorganizations" the courts have applied essentially the same criteria we urge here. Whether or not the transaction here could be technically characterized as a "reorganization"—which is at least arguable—the reorganization cases provide compelling analogies. The old cases distinguishing between liquidating distributions and dividends similarly turned upon the extent to which there was a "cut-off" of the stockholder's interest in the future exploitation of the assets and a realization instead upon their present value. Compare *Lynch* v. *Turrish*, 247 U.S. 221, with *Lynch* v. *Hornby*, 247 U.S. 339. The "thin capitalization" cases, which look to the adequacy of the credit cushion and the degree of risk borne by the noteholders to determine whether the notes should be treated as debt or equity interests, are even closer in point and may, indeed, be directly applicable to this case. A fuller development of those analogies must, however, await a brief on the merits.

either makes a substantial down payment, pledges other assets as security, assumes a meaningful personal liability (*i.e.*, of a solvent entity), or provides some other form of guaranty. The down payment or right of recourse against other persons or assets gives the seller a "cushion" to assure payment of the price regardless of the fortunes of the business and thus shifts the primary risk of business success or failure to the buyer. Bearing the risk of future losses, the buyer will insist upon the correlative benefits and will agree to pay only the present value of the business, retaining to himself the benefit of future earnings. By such a transaction, therefore, the seller gives up his interest in the future and settles for a realization of the already-accrued values. And because the buyer's obligation to pay the price has an existence and value independent of the future of the business, there is a meaningful "exchange" of the business for "other property"—a "conversion" of the seller's interest into something else.

Those characteristics are, in contrast, wholly lacking in the bootstrap transaction described above. Since *B* ventures nothing—neither assets, personal liability, nor management—the sole investment is *A*'s and *A* must continue to bear the full risk of future losses or capital depreciation. It is solely on *A*'s investment—whether identified by source or risk-bearing—that the future income of the business is earned. The price is not determined by economic forces and is necessarily greater than the cash value of the busi-

ness," so that its ultimate payment depends not merely upon the avoidance of future losses but upon the realization of future income. Thus *A*, far from opting for the present and leaving the future to others, has chosen instead to leave his investment at risk in the business in the hope that its future earnings will be sufficient to pay him a correspondingly greater amount. And since *Y*, the nominal "buyer," has no assets other than the business transferred by *A*, its "obligation" to pay the "purchase price" has no worth (or, indeed, meaningful existence) independent of the business, and there is, therefore, no "exchange" at all. *A* has simply imposed a limit on his previously unlimited rights to the assets and income of the business and given away for nothing the right to the residue after the "pay-out" of the prescribed amount. If our interpretation of the statute be correct, such a transaction is not a "sale."

3. The broad importance of the question, and the need for its resolution by this Court, is evident. As the Court is aware, a very large portion of all tax controversies involve claims to capital-gains treatment. The Code (§ 1222(3)) defines capital gains simply as gains from the "sale or exchange" of a "capital asset" (in turn defined, but for some specific exclusions, simply as "property," § 1221), and entitlement to the preferential treatment accorded such gains thus turns upon two fundamental questions of

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[*] Unless the transaction is donatively motivated, in which event it would amount to an assignment of the income earned at *A*'s risk on *A*'s investment.

definition: "What is a capital asset?" and "What is a sale?" Despite the generality of the statutory standard and the correspondingly broad responsibility for judicial interpretation, many of the lower courts have resorted to formalism in answering those questions, holding in effect (1) that, since a "capital asset" is defined simply as "property," any interest that is recognized as "property" by state law is *ipso facto* a "capital asset," and (2) that, since "sale" is undefined by the statute, any transaction that is treated as a "sale" by state law (*i.e.*, is effective to pass title) is *ipso facto* a "sale" for capital-gains purposes. This Court, in sharp contrast, has consistently looked to the underlying purposes of the statute and the economic substance of the transaction to determine whether capital-gains treatment is warranted. Its recent decisions, however, have directly involved only the "capital asset" question,[21] and its earlier decisions on the "sale" question, primarily in the natural-resources field, have unaccountably been ignored as often as they have been followed. As a consequence, there exists in the lower courts widespread conflict and confusion on the question, and the need for a restatement of basic principles by this Court has become urgent.

Transactions substantially identical to that involved here (*i.e.*, bootstrap sales to charities) have been held to be "sales", on equally formalistic grounds, by the

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[21] *E.g.*, *Commissioner* v. *Gillette Motor Co.*, 364 U.S. 130; *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260; *Corn Products Co.* v. *Commissioner*, 350 U.S. 46.

First Circuit and the Court of Claims.[11] In contrast, the Seventh Circuit, looking instead to the former owners' retention of the economic risks and benefits of the business, held such a transaction not to be a "sale." *Kolkey* v. *Commissioner*, 254 F. 2d 51. It is true that the transaction in that case was made particularly transparent by a "purchase price" many times the current value of the business and by the fact that the fortunes of the highly speculative business declined sharply soon after the transaction, precipitating a default and a reacquisition of the business by the "sellers." Because of those differences, the court below distinguished that transaction from the "genuine sale" in this case on the ground that "We think that the real holding in *Kolkey* was that the transaction was a sham" (App. 42). But that was not the rationale of the *Kolkey* opinion, and in every bootstrap sale the "purchase price" is necessarily wholly arbitrary—being determined only by tax considerations—and its payment entirely dependent on the continued good fortunes of the business. Despite the factual distinctions, therefore, there is, we submit, a basic conflict of principle between the decision below and that of the Seventh Circuit in *Kolkey*.

The divergencies and confusion are not confined to the particular type of transaction in issue here. In what seems to us perhaps the clearest departure by the lower courts from the "economic interest" prin-

[11] *Commissioner* v. *Johnson*, 267 F. 2d 382 (C.A. 1); *Union Bank* v. *United States*, 285 F. 2d 126 (Ct. Cls.); *Knapp Brothers Shoe Mfg. Corp.* v. *United States*, 142 F. Supp. 899 (Ct. Cls.).

ciple established by this Court's decisions, several courts of appeals have held that a transfer of a patent in exchange for a royalty based on the transferee's future sales of the patented item constitutes a "sale" of the patent and that the royalties received over the life of the patent are taxable only as capital gains.[23] The Second Circuit, however, rejects the "sale" characterization and holds the proceeds of the patentee's retained interest in the successful exploitation of the patent to be taxable as ordinary income.[24] That conflict has been resolved by statute as to certain patent transfers[25] but remains viable as to some of the most common, among them transfers to a controlled corporation, probably the class with the most important tax implications.[26] A similar conflict exists as to pur-

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[23] *Commissioner* v. *Celanese Corp.*, 140 F. 2d 339 (C.A.D.C.); *Allen* v. *Werner*, 190 F. 2d 840 (C.A. 5); *Watson* v. *United States*, 222 F. 2d 689 (C.A. 10); *Massey* v. *United States*, 226 F. 2d 724 (C.A. 7); *United States* v. *Carruthers*, 219 F. 2d 21 (C.A. 9); *Rollman* v. *Commissioner*, 244 F. 2d 634 (C.A. 4); *Kronner* v. *United States*, 110 F. Supp. 730 (Ct. Cls.). It should be noted, however, that in none of those cases was the "economic interest" principle briefed. If the royalty aspect was mentioned at all, it was referred to simply as one of the "factors"—together with, *e.g.*, retained powers of control—which indicated that the particular transfer was "really" a license rather than a sale.

[24] *Bloch* v. *United States*, 200 F. 2d 63 (C.A. 2). The conflict was noted in this Court's recent decision in *United States* v. *Zacks*, 375 U.S. 59, 63 n. 5.

[25] 1954 Code § 1235; 1939 Code § 117(q), added by Act of June 29, 1956, 70 Stat. 404. See *United States* v. *Zacks*, *supra*.

[26] In 1958, faced with a mounting tide of adverse decisions, the Internal Revenue Service finally acquiesced and ceased, for the time being, to litigate the issue. Rev. Rul. 58-353, 58-2 Cum Bull. 408.

ported "sales" of a franchise to use a trade name, with the "seller" retaining a right to royalties based on the franchised dealer's sales,[27] and other examples abound.[28]

A decision characterizing a single transaction cannot, of course, solve all the problems, and we do not ask the Court to do more than decide this case. Yet

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[27] See *Dairy Queen of Oklahoma* v. *Commissioner*, 250 F. 2d 503 (C.A. 10) (both lump sum payment and royalties are capital gain); *Gowdey* v. *Commissioner*, 307 F. 2d 816 (C.A. 4) (only lump sum is capital gain); *Moberg* v. *Commissioner*, 305 F. 2d 800 (C.A. 5) (same); *Moberg* v. *Commissioner*, 310 F. 2d 782 (C.A. 9) (neither lump sum nor royalties capital gain). In these cases, too, the significance of the royalty as *per se* a retained economic interest has been obscured by a reliance also on other factors.

[28] A transfer of land to a cemetery association in exchange for a percentage of its receipts from the resale of the land as burial lots has, for example, been held not to give the transferor an interest in the "income" of the association (*Commissioner* v. *Kensico Cemetery*, 96 F. 2d 594 (C.A. 2); *Forest Lawn Memorial Park* v. *Commissioner*, 45 B.T.A. 1091; but cf. *Sherwood Memorial Gardens, Inc.* v. *Commissioner*, 42 T.C. No. 12, decided April 17, 1964), while, to go to the other extreme, a transfer of property to a trust in exchange for the trust's payment of the gift taxes on the transfer (an obligation in a fixed amount, necessarily equal to only a fraction of the value of the property and thus more than adequately secured) has been held to be a retention of an "income" interest. *Sheaffer* v. *Commissioner*, 313 F. 2d 738 (C.A. 8), certiorari denied, 375 U.S. 818. Even in the natural-resources field, where this Court's earlier decisions, having dealt with the same subject matter, seem to have had more impact, there are sharp divergencies in the treatment of purported "sales" of sand and gravel deposits for a royalty based on the amount of production. Compare *Crowell Land & Mineral Corp.* v. *Commissioner*, 242 F. 2d 864 (C.A. 5), and *Linehan* v. *Commissioner*, 297 F. 2d 276 (C.A. 1), with *Laudenslager* v. *Commissioner*, 305 F. 2d 686 (C.A. 3), certiorari denied, 371 U.S. 947.

there now exists among the lower courts no core of agreement even as to the most generalized concept of what a "sale" is. A decision of this case, while not providing a blueprint for all subsequent cases, would at least negate some of the misconceptions and refocus attention on the relevant factors. The problem is pervasive, and the task, one that only this Court can perform.[29]

[29] It should be noted that a decision that such a transaction does not qualify as a "sale" would not automatically determine the proper tax treatment of the receipts from the retained interest. Such a transaction does have "substance"—primarily a shift of the residual interest but also an intervention of new legal entities—and does effect a real change in the nature of the former owner's interest. There would remain a question, therefore, how the retained interest should be classified and how the proceeds from it should be accounted for: as dividends (treating *A*'s notes in *Y* as "stock"); as proceeds from a joint venture (treating *A* and *Y* as "partners," with *A* providing the assets and *Y* the management); as income distributions on a trust analogy (treating the transaction essentially as a gift in trust with a retained income interest); simply as "gains" not otherwise provided for, taxable as income under § 61(a); etc. Those questions—which may, among other things, turn on the particular form the transaction takes—need not be explored here, however, and even if the case is heard on the merits the Court may prefer to decide only the basic question whether the transaction is a "sale" and leave to the lower courts on remand, at least initially, the question of the proper alternative characterization of the receipts. For the years involved in this case, moreover, we doubt that any of the possible alternative characterizations would make a difference in result. At least respondents have yet to claim any alternative characterization of their receipts (assuming the transaction is not a "sale") that would justify their treatment as anything other than ordinary income.

II.

While the tax treatment of the "seller" in a bootstrap sale turns on the same basic questions whether the "purhaser" is an exempt or non-exempt entity, it is in transactions with charities that the bootstrap technique has been most extensively exploited. The reason is obvious. At a 52% corporate income tax rate, $100,000 of business income yields only $48,000 after taxes in a taxable corporation but a full $100,000 if the business can be brought under the tax-exemption umbrella of a charitable foundation. In a bootstrap sale to a charity, therefore, the marriage of the charity's exemption with the business' income doubles the cash yield from the business, thereby not only giving the "seller" greater assurance that the "purchase price" can be paid (though payment is still dependent on there *being* income) but also permitting a much more rapid pay-out.[20] The transaction

[20] We do not, it should be noted, suggest that the fact that the buyer is tax-exempt will cause the "purchase price" to be any higher. As we have seen, there is no limit, other than tax caution, to the price that may be set in a bootstrap sale to a non-exempt buyer. The only difference is that, if the buyer is exempt, any given price may be paid faster and more surely. Indeed, an exempt purchaser has something real to contribute to the transaction—the use of its tax exemption—and thus, to a degree, has something to "bargain" about. If anything, therefore, an exempt buyer might be able to negotiate a somewhat lower "price" than the seller might choose to set, as he would be free to do, in a sale to a non-exempt purchaser. But while the "bargaining" might to that extent be more "real", its content is still entirely different from that of commercial bargaining and the resulting "price" continues to bear no inherent relationship to the present value of the business.

is an even greater boon to the charity. By virtue of its exemption, it is able to attract bootstrap sellers and thereby acquire ultimate ownership of valuable business properties with neither investment nor effort. It is able, in effect, to "capitalize" its tax exemption, using the exemption and nothing else to acquire a valuable business. Rather than simply relieving from tax the income earned on capital originally contributed by charitable benefactors, the tax exemption is transmuted: it becomes the very source of capital. If the bootstrap sale of a business to charity can withstand attack, business entrepreneurs have the magic means of converting ordinary business income into capital gains and charities the key to 100% federal financing of their activities.[21]

[21] The effects of the transaction can be illustrated by returning to our original example of *A*'s corporate business with after-tax earnings of $100,000 (approximately $200,000 before taxes) and a cash value of $500,000. If the business is operated for 10 years and then sold for its cash value, its total cash yield (assuming constant income and values) will be $2,500,000. If *A* retained the business throughout the period, the corporation would pay $1,000,000 in corporate income taxes, and *A* would pay $800,000 in individual income taxes (at 80%) on the remaining $1,000,000 of business income distributed as dividends, plus $125,000 in capital gains taxes on the cash sale. The $2,500,000 yield would thus be distributed $1,925,000 in taxes to the government and $575,000 to *A*. If, instead, *A* made a bootstrap sale of the business to Charity for $2,000,000 payable $200,000 a year for 10 years, and after the pay-out Charity sold the business for $500,000, no corporate income taxes would be paid, *A*'s $2,000,000 receipts would be subject only to a $500,000 capital gains tax, and no tax would be paid on Charity's sale of the business. The $2,500,000 total yield from the business would thus be distributed $500,000 in taxes

1. While Congress has never addressed itself to the tax treatment of bootstrap sellers, it has attempted to prevent the exploitation of the charitable exemption in such transactions. It is that attempt that explains the rather indirect and complicated form of the transaction in this case.

Bootstrap sales to charity were originally cast in a form identical to the transaction described above except that the "buying" corporation (*Y*) would be organized, with a nominal initial contribution, as a "feeder" to some established charity—*i.e.*, its charter would require it ultimately to pay over its income and assets to the "parent" foundation. It is in that form, for example, that a "feeder" for New York University, with an initial capitalization of $1,000, "bought" the Howes Leather Company for $30 million. *Commissioner* v. *Johnson*, 267 F. 2d 382 (C.A. 1). For similar transactions, see *Knapp Brothers Shoe Mfg. Corp.* v. *United States*, 142 F. Supp. 899 (Ct. Cls.); *Kolkey* v. *Commissioner*, 254 F. 2d 51 (C.A. 7); *Ohio Furnace Co.* v. *Commissioner*, 25 T.C. 179; *Truschel* v. *Commissioner*, 29 T.C. 433; *cf. Caldwell* v. *Campbell*, 218 F. 2d 567 (C.A. 5). A somewhat different transaction, also being widely exploited at

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to the government, $1,500,000 to *A*, and $500,000 to Charity. Thus, not only would *A*'s receipts be converted into capital gains, but the $1,000,000 in corporate income taxes "saved" by virtue of the charitable exemption would be divided equally between *A* and Charity. In effect, Charity "buys" the business with its tax exemption, at a cost to the Treasury—*i.e.*, to other taxpayers—of $2 for every $1 Charity ends up with, a result that might better be described as 200% federal financing.

the time, was the "sale and lease-back," in which a business "sold" its real property or equipment to a charity and simultaneously "leased" it back on a long-term lease. The charity would borrow the purchase price from a third party on the security of the property and the lease and then pay off the loan out of its tax-free rentals under the lease (appropriately tailored to the purpose)." Once again, the charity, with no investment of its own, was able to "capitalize" its tax exemption into eventual ownership of the property.

In the Revenue Act of 1950, § 301, 64 Stat. 948, Congress attempted to stop such transactions. It did so by providing that corporations engaged solely in operating a business and paying the income over to another charity ("feeders") would no longer be exempt (now § 502) and that foundations which engaged both in business and in charitable activities would be taxable on their "unrelated business income" (§ 511). While so-called "passive" income in the form of dividends, interest, rents, *etc.*, continued to be exempt, in order to prevent the "lease-back" device it was further provided that rentals under long-term leases (more than five years) of property purchased on credit would also be taxable (§ 514).

In explaining the reason for the "feeder" and "unrelated business income" provisions, the commit-

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" See Cary, *Corporate Financing Through the Sale and Lease-Back of Property*, 62 Harv. L. Rev. 1; Note, *Taxation of Sale and Lease-Back Transactions*, 60 Yale L. J. 879.

tee reports noted the unfair competitive advantage tax-exempt businesses were thought to have and added:[23]

> * * *. Also, a number of examples have arisen where these organizations have, in effect, used their tax exemption to buy an ordinary business. That is, they have acquired the business with no investment on their own part and paid for it in installments out of subsequent earnings—a procedure which usually could not be followed if the business were taxable.

In explaining the objections to the lease-back device, the committees noted that "the tax-exempt organization is not merely trying to find a means of investing its own funds at an adequate rate of return but is obviously trading on its exemption," with "the fact that it pays no income tax on the rentals received" being "the only reason why it receives the property at no expense to itself." The fact that a charity "need not use any of its own funds" also meant that "there is no limit to the property an exempt institution may acquire in this manner," creating a threat that "exempt organizations in the not-too-distant future may own the great bulk of the commercial and industrial real estate in the country." The committees noted also that a possibility "exists in each case that the exempt organization has in effect sold part of its exemption" by either "paying a higher price for the property or by charging lower rentals than a taxable

[23] H. Rep. No. 2319, 81st Cong., 2d Sess., pp. 36–37; S. Rep. 2375, 81st Cong., 2d Sess., pp. 28–29.

business could charge"—a possibility which, although "difficult" to prove, arises from the fact that, since the arrangement "does not require the commitment of any of its own funds," the normal economic restraints are absent.[24]

The transaction in this case, it may be seen, is carefully designed to skirt that remedial legislation. To avoid the "feeder" provision, the stock is sold to the Institute itself, but with its liability being contractually limited to the assets transferred in order to achieve an equivalent insulation of the Institute from the risks of the business. To avoid the "unrelated business income" tax, the business is then "leased" to a newly-formed operating company with the payments, although measured by 80% of the net income of the business before depreciation or taxes, being labelled "rent" and therefore, hopefully, not taxable as "business income." To avoid the tax on rentals from long-term leases of debt-burdened property, the lease is limited to five years, with new arrangements then to be made if the income has not been sufficient by that time to complete the pay-out (see R. 26–27). The transaction, in short, is the same in economic substance as the old direct form of a bootstrap sale to a feeder but has been "gerrymandered" around the 1950 amendments designed to prevent such transactions.

While the bootstrap sale to a charity in its most recent dress may pose new and substantial questions

[24] H. Rep. No. 2319, *supra*, pp. 38–39; S. Rep. No. 2375, *supra*, pp. 31–32.

as to the tax treatment of the purchasing charity,[35] from the seller's point of view the transaction is substantially identical to the earlier form of bootstrap sales to feeders or, for that matter (but for the added advantage of a quicker and surer pay-out), to bootstrap sales to non-exempt purchasers. And it is, of course, only that question—whether the transaction should be treated as a "sale" for purposes of the tax treatment of the owners—that is directly involved here.

2. The increasing exploitation of the bootstrap technique in sales to charities makes urgent the need for review of the basic "sale" question, for that is the predicate upon which the transactions are built. As the extensive discussion of such transactions in the tax literature[36] suggests, the technique has already been widely employed. The decisions reported to date involving such transactions include not only the six cases cited above (p. 26) involving sales to "feeders" but also the following cases involving the "sale and lease" arrangement: *Union Bank* v. *United*

[35] In particular, the labeling of the 80%–20% profit-sharing agreement with the operating company as a "lease" rather than as a "joint venture" or a "management contract" (the operating company being given 20% of the net profits as its fee for managing the business on behalf of the Institute), seems to us a transparent attempt to make tax consequences turn on mere labels and form rather than economic substance. And there remains the old question whether such transactions, resulting in the benefit of the tax exemption accruing in part to the private sellers, do not result in the foundation's being operated for other than "exclusively charitable" purposes, thus causing a complete loss of its exemption.

[36] See note 13, *supra*.

States, 285 F. 2d 126 (Ct. Cls); *Anderson Dairy, Inc.* v. *Commissioner*, 39 T.C. 1027; *Royal Farms Dairy Co.* v. *Commissioner*, 40 T.C. 172; *Singer* v. *Commissioner*, 1963 P-H T.C. Mem. Dec. ¶ 63,158; *Isis Windows, Inc.* v. *Commissioner*, 1963 P-H T.C. Mem. Dec. ¶ 63,176; *Brekke* v. *Commissioner*, 40 T.C. 789; *Estate of Hawley* v. *Commissioner*, 1961 P-H T.C. Mem. Dec. ¶ 61,038; cf. *Estate of Hawthorne* v. *Commissioner*, 1960 P-H T.C. Mem. Dec. ¶ 60,146. The first six of those cases all involved transactions with a single foundation (the University Hill Foundation, associated with Loyola University) which, we are advised, has now purchased a total of 26 different businesses, at an average price of $1.3 million each, in transactions substantially identical to that in this case—that is, without the investment of a single dollar of its own funds and using nothing more than its tax exemption. The cases now pending administratively or in court involve an estimated $26 million in taxes (including, in some cases, deficiencies asserted against the foundation or the operating company), and there is good reason to believe that there have been many other bootstrap transactions that have gone unnoticed or unchallenged. Adding to the need for review by this Court without awaiting further developments in the lower courts is the fact that all of the cases now pending in court are within the jurisdiction of the court below[37] and that the Court of Claims, a forum avail-

[37] Petitions for review of the *Anderson Dairy*, *Royal Farms*, *Singer*, and *Isis Windows* cases, *supra*, are already pending in that court and are being held in abeyance to await the final disposition of this case.

able to all taxpayers, has also held such transactions to be "sales." *Union Bank, supra.*

Even more serious are the implications for the future—social and economic as well as fiscal—if the decision below is allowed to stand. In 1950, the Congressional committees described the "lease-back" arrangement as "the most noteworthy financial device of the present century" and one which, because of the unlimited means it afforded charities to acquire property with no investment of their own, could lead to ownership by charities of "the great bulk of the commercial and industrial real estate in the country."[38] The bootstrap transaction now being exploited not only offers the same opportunities to exempt organizations as did the lease-back device—the ability to make unlimited acquisitions of business properties with no investment of their own—but affords far greater tax advantages to the "sellers." If the decision below be the law, there is no reason for any high-bracket owner of a business to continue to pay a dividend tax on its earnings. The success to date of a single foundation (and there are over 50,000 of them) in finding 26 different businesses to buy "for nothing" suggests the likely outcome.[39]

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[38] H. Rep. No. 2319, 81st Cong., 2d Sess., pp. 38, 39; S. Rep. No. 2375, 81st Cong., 2d Sess., p. 31.

[39] Note that the transaction here was initiated by the Institute, that its plan had been prepared by the same attorney who had worked out the sales to the University Hill Foundation, and that, by the time of trial, it had investigated some two dozen business acquisitions and undertaken two (R. 23–24, 36).

The principal deterrent to such transactions thus far has been the fear that the tax treatment on which they depend might be successfully challenged. With the Ninth Circuit now having joined the First Circuit and the Court of Claims in upholding the "sale" treatment of such transactions (and with the Seventh Circuit's contrary decision in *Kolkey* explained away as merely a warning to taxpayers to be somewhat more discreet in setting the terms), the deterrent is fast disappearing. In the most recent article advertising the benefits of such transactions, the sole precautionary note is the advice that taxpayers embarking on bootstrap sales would do well to wait until the decision of the court of appeals in this case becomes final.[40]

The bootstrap sale of a business to charity is a transaction that has no reason for being other than tax avoidance. The conversion of ordinary income into capital gains that it seeks is neither required nor justified by the statute, and the decisions holding otherwise have been criticized no less by private tax practitioners (Moore and Dohan, *Sales, Churches, and Monkeyshines,* 11 Tax L. Rev. 87 (1956)) than by former government attorneys (Lanning, *Tax Erosion and the "Bootstrap Sale" of a Business,* 108 U. of Pa. L. Rev. 623 (1960)). Even lay publicists have noted the abuse as a prime example of the inequitable administration of the tax laws. Stern, *The Great Treasury Raid,* p. 245 (1964). The question is one of major importance and deserves review by this Court.

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[40] *New Developments in Tax-Exempt Institutions*, 19 Journal of Taxation 302 (1963).

The court below, having reached a concededly unpalatable result, suggested that the remedy lay with Congress (App. 43). The demonstrated inefficacy of the 1950 amendments should, however, suggest that the answer is not to be found in a particularized legislative response to particularized transactions. The problem is much more fundamental than that; it calls not for the plugging of leaks but for a return to basic principles in the application of the necessarily general provisions of the Code defining capital gains. Deviations from principle always spawn devices to exploit them, and, so long as the basic error remains uncorrected, a new device will take the place of each one struck down by particularized legislation.

Nor can Congress reasonably be asked to essay a specific definition of "sale." The dangers inherent in overly specific legislation are familiar,[41] and in a statute designed to apply to such a multitude of ever-changing transactions as is the Internal Revenue Code there is no alternative to the employment of general concepts, leaving to the courts the responsibility of applying them to particular transactions in a way which serves the underlying purpose. This Court has accepted the responsibility in the past, and no more is now required, we believe, than a reiteration of the

[41] See the history recounted in *Commissioner* v. *Korell*, 339 U.S. 619, and *Hanover Bank* v. *Commissioner*, 369 U.S. 672, for an example of what may (and all too often does) happen when a problem susceptible of flexible solution under a generalized provision of the Code is sought to be solved by particularized legislation.

principles already established by its earlier decisions but widely overlooked by the lower courts.

The petition for certiorari should be granted.

Respectfully submitted.

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APRIL 1964.

APPENDIX

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

Nos. 18,228–18,233

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CLAY B. BROWN and DOROTHY E. BROWN, DONALD L. BROWN and INGRID R. BROWN, CHARLES WILLIAM BOOTH and NANCY H. BOOTH, DONALD LEE BROWN, PHILIP F. BROWN, MARILYN BROWN, RESPONDENTS

Petition to Review a Decision of the Tax Court of the United States

December 10, 1963

Before: HAMLIN and DUNIWAY, Circuit Judges and KUNZEL, District Judge

DUNIWAY, *Circuit Judge:* The Commissioner of Internal Revenue asks us to reverse decisions of the Tax Court. We are of the opinion that the decisions must be affirmed.

Involved is a transaction of the type described by Moore and Dohan in an article entitled: "Sales, Churches and Monkeyshines," 11 Tax L. Rev. 87 (1956), and by Lanning in an article entitled: "Tax Erosion and the 'Bootstrap Sale' of a Business," 108 U. of Pa. L. Rev. 623 (1960). The transaction is described in great detail in the findings of the Tax Court, which are reported at 37 T.C. 461. In his

opening brief the Commissioner states: "No exception is taken to the detailed basic findings of the Tax Court." In the same brief the Commissioner summarizes what he contends are the essentials of the transaction. We quote the summary, but with additions, in brackets, from the record:

> "Taxpayers, consisting of Clay Brown, his wife and three children, and the two Booths, owned substantially all of the stock of Clay Brown & Company, which had lumber interests and saw mills near Fortuna, California. Although the total cost basis of their investment was only $42,000, the accumulated surplus of the corporation at January 31, 1953 was $448,472, and prospects of future earnings were good.
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> In the summer of 1952, Clay Brown, the president of the corporation and spokesman for the other stockholders, was approached by a representative of the Institute, a tax-exempt corporation, who supplied him with brochures describing the tax advantages of a particular type of 'sale' transaction. [There was considerable bargaining, at arms length, and a price was agreed upon that was within a reasonable range in light of the earnings history of the corporation and the adjusted net worth of its assets.] When, as it happened, taxpayers agreed to the plan, a complex set of interrelated legal documents was drafted to give it effect. Pursuant to the overall plan agreed upon in advance, the following steps were taken:
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> (a) Taxpayers endorsed and delivered all of their shares in the corporation to the Institute, together with $125,000 face amount of promissory notes of the corporation held by Clay Brown and his wife. On the same day, February 4, 1953, the Institute delivered to taxpayers its promissory note in the face amount of $1,300,000. The note, which was to mature

approximately 10 years later, was nonnegotiable and noninterest bearing. The Institute assumed no liability for payment of the note from its own assets. Payment of the purchase price was to be made solely out of amounts received by the Institute as 'rental' income of the business assets, of which 90 percent would be turned over to taxpayer as periodic installments.

(b) The Institute was left no option as to the disposition of the property, which was provided for in predrafted instruments. The following steps were taken pursuant to the plan: (1) the corporation was dissolved; (2) $5,000 of the current assets was turned over to taxpayers as a down payment; (3) the remaining net current assets were 'sold' for another promissory note to a new corporation, Fortuna Mills, Inc., organized by taxpayer Clay Brown's attorneys for the specific purpose of taking over the business of the dissolved corporation; [All of the issued stock of Fortuna was purchased by the attorneys, with their own funds, for $25,000.] (4) all of the other assets were mortgaged back to taxpayers, permitting reacquisition of [that portion of] the business assets in the event of default on the installments on the purchase price; (5) the same assets were 'rented' by the Institute to Fortuna for 80 percent of the net profits of the business, without allowance for taxes or depreciation. The Institute, retaining 10 percent of this amount, was obligated to turn over the balance to taxpayers to be applied toward the purchase price.

(c) As part of the plan, taxpayer Clay Brown was employed as 'general manager' of Fortuna at an annual salary of $25,000, and it was provided that if he ceased to act as general manager, his successor would be selected by taxpayers. He exercised substantially the same powers as those which he had as president of the dissolved corporation, and no property could be

sold without his consent. Moreover, Brown personally guaranteed mortgage loans of the old company transferred to Fortuna, and he also personally guaranteed another $50,000 loan to Fortuna, which had been capitalized at only $25,000.

The new Fortuna corporation took over the operation of the business, which continued for 4½ years on the same premises, with the same operating personnel and under practical control of taxpayers. On June 19, 1957, after suffering business reverses, Fortuna shut down the mill on word from Clay Brown. Taxpayers did not exercise their option to declare a default and formally reacquire their property by foreclosure. Instead, they arranged for the Institute to sell the assets, retaining 10 percent of the proceeds. The assets, which had been appraised prior to the original 'sale' to the Institute at more than $1,000,000 were sold at only $300,000, to outsiders at sometime in July, 1959. Taxpayer received 90 percent of the proceeds. Steps were taken at that time to settle out and cancel all of the tricornered arrangements between Fortuna, the Institute and taxpayers. The net financial result of the plan was that taxpayers received a total of $936,131.85."

We think we should add to this summary certain additional findings and conclusions of the Tax Court which are:

1. That there was a change of economic benefits in the transaction.

2. That the primary motivation of the Institute was the prospect of ending up with the assets free and clear after the purchase price had been fully paid, which would then permit the Institute to convert the property into money for use in cancer research.

In the court below the Commissioner took two alternative positions: One was that the transaction was a

sham. This position is abandoned here. The other, which the Commissioner also takes before us, was that the Tax Court erred in holding that there was a sale within the meaning of section 117(a) of the Internal Revenue Code of 1939 and section 1222(3) of the Internal Revenue Code of 1954 because, so the Commissioner says, certain normal aspects of the sale of a business were missing. These are (1) shift of business risk; (2) shift of benefit of income; (3) shift of operational control; (4) permanent shift of ownership of assets and (5) release of sellers from business indebtedness. The Commissioner relies upon *Burnet v. Harmel,* 1932, 287 U.S. 103 as to shift of business risk, upon *Helvering v. Clifford,* 1940, 309 U.S. 331 as to shift of benefit of income, and on *Commissioner v. Sunnen,* 1948, 333 U.S. 591 as to shift of operational control.

We think that the Commissioner's contentions are well answered in the opinion of the Tax Court, and also in the following cases: *Commissioner v. Johnson,* 1 Cir., 1959, 267 F.2d 382; *Union Bank v. United States,* Ct. Cl., 1961, 285 F.2d 126.

Here, as in those cases, there was a transfer of title; there was a shift of business risk in the sense that the operation of the business was in the hands of a new company owned by third persons, albeit managed under a contract by one of the taxpayers; there was a shift of benefit of income in the sense that Fortuna retained 20% of it and the Institute retained 10% of 80%; there was no understanding that the assets were to come back to the taxpayers under any circumstances other than a default in the payment of the purchase price; there was a permanent shift of ownership of assets. The management contract and the guarantee of certain of Fortuna's borrowings by one of the taxpayers (Clay Brown), were designed

to secure the payment of the price. There was no understanding that, if the business should be unsuccessful, Brown would take action to "trigger" a default, thus causing a reversion of the mortgaged assets to the taxpayers. As was said by the court in *Commissioner v. Johnson, supra,* "The mere fact that the security holders may in the future have to resume proprietorship of the enterprise does not nulify the fact that they had sold those proprietary interests." (267 F.2d at 385)

The Commissioner relies also on *Kolkey v. Commissioner,* 7 Cir. 1958, 254 F.2d 51. This case was distinguished in *Commissioner v. Johnson, supra,* on the ground that in *Kolkey* the facts were different and the Tax Court had found, in substance in that case, that there was no sale. The Tax Court made the same distinction here, and we think it was correct. We think that the real holding in *Kolkey* was that the transaction was a sham. Here, the finding is the other way and the evidence sustains it.

There is no question that this transaction took the form that it did because the Institute is a tax-exempt corporation and that the price to be paid was probably greater for that reason. These facts may have some relevance in connection with possible tax liabilities of the Institute, but they do not, as a matter of law, establish that, so far as the taxpayers were concerned, the sale of their stock was not a genuine sale, which is the only issue involved in this case.

We think that it is of some significance that the problem of misuse by tax-exempt organizations of their tax exemption in transactions similar to this was considered by the Congress, which adopted certain remedial legislation in the Revenue Act of 1950. The history of this legislation appears in H.R. Rep. No. 2319, 81st Cong. 2d Sess., 1950–2, Cum. Bull. 330, 408–

11, and in S. Rep. No. 2375, 81st Cong. 2d Sess., 1950–2, Cum. Bull. 483, 502 ff. Certain aspects of the transaction now before us were undoubtedly "tailored" to fit the law as amended by Congress in 1950, particularly section 101 of the Revenue Act of 1939 as amended, and sections 421, 422, and 423. These sections all relate to the income and tax exempt status of the purchasing Institute; none of them purports to deny to the sellers, the right to treat the sale, for tax purposes, as a sale, and therefore to treat moneys received as capital gains. Congress could have dealt with that aspect of such transactions but did not do so. If, as is indicated by the writers of the articles cited at the beginning of this opinion, the present situation, insofar as the tax position of the sellers is concerned, is undesirable from a tax standpoint, it is still possible for Congress to provide a remedy.

Affirmed.

(Endorsed) Opinion Filed Dec. 10, 1963.

FRANK H. SCHMID, *Clerk.*

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 18228[1]

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CLAY B. BROWN, ET AL., RESPONDENT

Judgment

Upon Petition to Review a Decision of The Tax Court of the United States, _____

_____

_____

This Cause came on to be heard on the Transcript of the Record from The Tax Court of the United States,

_____

_____

_____ and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the _____ Decision of the said Tax Court of the United States in this Cause, be, and hereby is affirmed.

Filed and entered December 10, 1963

[1] Identical judgments were entered on the same date in favor of Donald L. and Ingrid R. Brown (No. 18229), Charles William and Nancy H. Booth (No. 18230), Donald Lee Brown (No. 18231), Philip F. Brown (No. 18232), and Marilyn Brown (No. 18233).

U.S. GOVERNMENT PRINTING OFFICE: 1964